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SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1941

No. 147

M. A. HOLMES,

Petitioner,

vs.

CHARLES J. McCOLGAN, AS BANK AND CORPORATION FRANCHISE TAX COMMISSIONER OF THE STATE OF CALIFORNIA.

PETITION FOR WRIT OF CERTIORARI TO THE SUPREME COURT OF THE STATE OF CALIFORNIA AND BRIEF IN SUPPORT THEREOF.

RALPH D. BROWN,
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INDEX.

Subject Index.

	Page
Petition for writ of certiorari	1
Statement of the matter involved	2
Statement of the basis upon which this Court has jurisdiction	3
Questions presented	3
Reasons why the writ of certiorari should issue	4
Prayer for writ	8
Brief in support of petition	9
Opinion of the court below	9
Statement of the case	10
Summary of Argument	11
Point I—The provision of the first Personal Income Tax Act of California making it apply to the gains upon a voluntary sale realized after the applicable date but before the effective date of the Act is unconstitutional	16
Point II—The provision of the first Personal Income Tax Act of California taxing income resulting from capital increment accrued prior to the date from which the act was made applicable is unconstitutional	21
A. Such a provision is so arbitrary and capricious as to amount to a denial of due process of law	21
B. Such provision of the Act also constitutes a denial of the equal protection of the laws	25
Point III—The decision of the Supreme Court of California in this case is based upon a misconception and misapplication by that court of the decisions of this Court	26

Page

Point IV—The decision of the Supreme Court of California in this case is in conflict with the decisions of the courts of last resort of other states 28
Conclusion 29

Appendix:

Pertinent provisions of the California Personal Income Tax Act of 1935 30
Pertinent provisions of the Revenue Act of 1934 31
Section 1 of the Fourteenth Amendment to the Constitution of the United States 3
Opinion of the California Supreme Court in this case 33

TABLE OF CASES CITED.

Blodgett v. *Holden*, 275 U. S. 142, 72 L. Ed. 206 .... 5, 12
Brushaber v. *Union Pacific R. R. Co.*, 240 U. S. 1, 60 L. Ed. 493 ..... 17, 20, 26
Coolidge v. *Long*, 282 U. S. 582, 75 L. Ed. 562 .... 3, 5, 13
Eisner v. *Macomber*, 252 U. S. 189, 64 L. Ed. 521 ... 7, 26
Fullerton Oil Co. v. *Johnson*, 2 Cal. (2d) 162, 39 P. (2d) 796 ..... 5, 26
MacLaughlin v. *Alliance Ins. Co.*, 286 U. S. 244, 76 L. Ed. 1083 ..... 5, 7, 11, 26
Merchants Loan & Trust Co. v. *Smietanka*, 255 U. S. 509, 65 L. Ed. 751 ..... 7, 26
Milliken v. *United States*, 283 U. S. 15, 75 L. Ed. 809 11, 14
Nichols v. *Coolidge*, 274 U. S. 531, 71 L. Ed. 1184 ... 5, 12, 13
Norman v. *Bradley*, 173 Ga. 482, 160 S. E. 413 ..... 6, 28
State Revenue Commission v. *Lazear*, 179 Ga. 167, 175 S. E. 451 ..... 6, 7, 28
State v. *Nygaard*, 163 Wis. 307, 158 N. W. 87 ..... 6, 28
Stockdale v. *The Insurance Companies*, 20 Wall. 323, 22 L. Ed. 348 17
Trefry v. *Putnam*, 227 Mass. 522, 116 N. E. 904 .... 6, 28
Untermyer v. *Anderson*, 276 U. S. 440, 72 L. Ed. 645 . 5, 13
Welch v. *Henry*, 305 U. S. 134, 83 L. Ed. 87 ..... 17, 25, 26

Page

OTHER AUTHORITIES CITED.

California Personal Income Tax Act of 1935 (Cal. Stats. 1935, Ch. 329, p. 1090) (See Appendix pages 38-39 infra.) 2, 3, 10
Revenue Law of 1934 (See Appendix page 40 infra.) 22
California Constitution of 1879, Article XIII, sec. 11 12
Amendment XIV, sec. 1, to the Constitution of the United States 3
Opinion of the California Supreme Court in this case 33

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PETITION FOR A WRIT OF CERTIORARI.

To the Honorable Chief Justice and Associate Justices of the Supreme Court of the United States:

Your petitioner, M. A. Holmes, respectfully prays for a writ of certiorari herein to review a certain final decision of the Supreme Court of the State of California, being the highest court of said State, in the above entitled matter, the opinion and decision of said court having been rendered and filed February 20, 1941 (R. 19), and a petition for rehearing having been thereafter denied March 20, 1941 (R. 25). By this decision the said court held that the Fourteenth Amendment to the Constitution of the United States is not violated by the California Personal Income Tax Act of 1935, in imposing an income tax on capital gain *accrued* prior to but *realized* after the applicable date of the Act, and

that therefore the petitioner could not recover an income tax deficiency assessed against him which he paid under protest.

Statement of the Matter Involved.

The California Personal Income Tax Act of 1935 (1935 Cal. Stats., Chap. 329, page 1090) was approved and became effective June 13, 1935, and imposed, for the first time in the State, an income tax on all individual incomes received after January 1, 1935, and with respect to the determination of income from capital gains adopted by reference Sections 111, 112, and 113 of the Federal Revenue Act of 1934. An income tax was thereby imposed on all capital increment (when realized) which accrued prior to the commencement date of the California Act and subsequent to March 1, 1913. Petitioner brought this action to recover a deficiency income tax assessment of $2,137.36 paid by him under protest, imposed, under the California Act, upon the realization of capital increment which had accrued in its entirety prior to the commencement date of the Act.

The constitutional question was originally raised by the complaint (R. 1-17, particularly 7-8) and the general demurrer (R. 17) thereto, necessarily admitting all the facts alleged in the complaint. The Federal right was decided adversely to the petitioner by the judgment of the court of first instance (R. 18) and by the Supreme Court of the State of California in affirming such judgment (R. 25). The opinion of the Supreme Court of the State of California sets forth that there was no increase in the value of the property involved between January 1, 1935, the applicable date of said Personal Income Tax Act and the date of sale thereof (R. 20), but upholds the respondent Franchise Tax Commissioner in treating the difference between the cost of the property and the selling price thereof as taxable

income in spite of the contentions of petitioner set forth in said opinion as follows: That on January 1, 1935, the property constituted a capital asset and that the proceeds from the sale thereof represented a return of capital and not income and that the Act could not be applied to such proceeds without violating the Fourteenth Amendment to the Constitution of the United States (R. 20, 21).

A copy of the opinion of the Supreme Court of the State of California (being the only opinion rendered in this matter) and of the pertinent provisions of the statutes involved are appended to the brief supporting this petition.

Statement of the Basis Upon Which This Court Has Jurisdiction to Review the Judgment in Question.

This cause draws in question the validity of a State statute, to wit: California Personal Income Tax Act of 1935 (Calif. Stats. 1935, Chap. 329, p. 1090) on the ground of its being repugnant to the Fourteenth Amendment to the Constitution of the United States and this Court has jurisdiction to review the same under Section 237(b) of the Judicial Code of the United States. See *Coolidge* v. *Long*, 282 U. S. 582, 75 L. Ed. 562; *Towne* v. *Eisner*, 245 U. S. 418, 62 L. Ed. 372. The decision sought to be reviewed was rendered February 20, 1941 (R. 42 and 52), and a petition for rehearing thereof was denied on March 20, 1941 (R. 53). The time in which a petition for certiorari may be filed is computed from the date of denial of rehearing under *Gypsy Oil Company* v. *Esco*, 275 U. S. 498, 72 L. Ed. 393, and *Citizens Bank of Michigan City* v. *Opperman*, 249 U. S. 448, 63 L. Ed. 701.

Questions Presented.

Two questions are presented under Section 1 of the Fourteenth Amendment to the Constitution of the United States with respect to the retroactive provisions of the Personal

Income Tax Act of 1935 of California that became effective on June 13, 1935 (said Act being the first personal income tax law in the State of California), as such provisions apply to a capital gain that had wholly accrued before January 1, 1935. These two questions are:

1. Is said section violated by the provision of the Act making it apply retroactively to such a capital gain realized on or after January 1, 1935, but before June 13, 1935?

2. Is said section violated by the provision of the Act incorporating by reference sections 111, 112 and 113 of the Federal Revenue Act of 1934, thereby making March 1, 1913, value, or subsequent cost, the basis upon which such capital gain shall be computed?

Reasons Why the Writ of Certiorari Should Issue.

1. The decision of the Supreme Court of the State of California in this case has decided both of the questions presented in the negative. They present Federal questions of substance not heretofore determined by the Supreme Court of the United States.

The California Personal Income Tax Act of 1935 in question was the first personal income tax act in the State, having been enacted June 13, 1935, to tax all personal income received after January 1, 1935. As construed by the California Supreme Court in this matter, the Act taxes as income all capital gain realized after January 1, 1935, although resulting from an enhancement in value during any period subsequent to March 1, 1913, but does not tax a similar gain realized before January 1, 1935. The March 1, 1913, date is arbitrarily adopted through incorporation by reference in the California Act of the United States Revenue Act of 1934 and has no reasonable relation to the inception date of the California tax on incomes. This Court has never heretofore decided whether a State may consti-

tutionally impose an income tax on capital increment accruing before but realized after the applicable date of the first personal income tax law adopted by said State. The decision of this Court in *MacLaughlin* v. *Alliance Ins. Co.*, 286 U. S. 244, 76 L. Ed. 1083 (relied upon in *Fullerton Oil Co.* v. *Johnson*, 2 Cal. (2) 162, 39 Pac. (2) 796, upon which the California Supreme Court bases its decision in the instant case) is not determinative of the matter. In that case the retroactivity of the Revenue Act of 1928, which was there involved, to gains previously accrued was sustained on the theory that Congress had theretofore established a policy of taxing such gains and that there was no attempt to tax the enhancement in value prior to the establishment of such policy.

The decisions of this Court in the gift tax cases are upon an analogous situation. No different principle is involved, they appear to be persuasive, and petitioner submits that they should be followed in this case. The cases referred to are: *Nichols* v. *Coolidge*, 274 U. S. 531, 542, 71 L. Ed. 1184; *Blodgett* v. *Holden*, 275 U. S. 142, 72 L. Ed. 206; *Untermeyer* v. *Anderson*, 276 U. S. 440, 72 L. Ed. 645; and *Coolidge* v. *Long*, 282 U. S. 582, 75 L. Ed. 562.

It is of importance both from the standpoint of administering the Personal Income Tax Act of California and from the standpoint of the taxpayers of California that the Federal questions involved be decided.

2. A decision of the second question presented is of major importance because of the number of States now without personal income tax laws that, under existing economic conditions, will undoubtedly soon be forced to adopt such a law. In adopting such a law and establishing by it a policy of taxing realized capital gains, such States should know how far they can go into the past in fixing a date as a basis from which capital gains may be constitutionally computed

and taxed. Until this question is decided by this Court, such States will be in uncertainty as to whether, if they follow the example set by the State of California and provide that capital gains arising from and after March 1, 1913, may be taxed, such a provision will be constitutional. Petitioner submits that it is in the interest of public welfare that this uncertainty be removed.

3. The decision of the Supreme Court of the State of California in this case results in a conflict between it and the decisions of the courts of last resort of certain States concerning Federal questions of substance, and a decision by this Court is necessary for the purpose of securing uniformity therein.

The decision of the California Supreme Court in this matter indicates that there is no limit to a State's power to impose an income tax on the realization of capital gain accrued before the taxing act was enacted. A contrary conclusion was reached by the Supreme Court of the State of Wisconsin in *State* v. *Nygaard*, 163 Wis. 307, 158 N. W. 87.

The decision of the Supreme Court of California also conflicts with opinions expressed by the Supreme Court of the State of Georgia (*Norman* v. *Bradley*, 173 Ga. 482, 160 S. E. 413, and *State Revenue Commission* v. *Lazear*, 179 Ga. 167, 175 S. E. 451), and the Supreme Judicial Court of Massachusetts (*Trefry* v. *Putnam*, 227 Mass. 522, 116 N. E. 904). The decisions in Wisconsin and Georgia arose in each case under the first personal income tax laws enacted in those States, and as to gains that had accrued prior to the applicable date of the respective laws they were held unconstitutional. Two situations were presented by the facts in the case of *Norman* v. *Bradley, supra,* but as to the gains on the sale of capital assets made after the applicable date and before the effective date of the law it was decided

that they were not taxable. The latter decision was followed in *State Revenue Commission* v. *Lazear*, 179 Ga. 167, 175 S. E. 451.

4. The opinion of the Supreme Court of the State of California in the above case is based upon a misconception and a misapplication by the court of the decisions of this Court concerning a Federal question, which misconception and misapplication should be corrected.

The cases of *Merchants Loan and Trust Company* v. *Smietanka*, 255 U. S. 509, 65 L. Ed. 751, and *Eisner* v. *Macomber*, 252 U. S. 189, 64 L. Ed. 521, upon which the California Supreme Court relies in its opinion in the instant case, do not support its conclusions, the former case holding only that capital increment accruing after the first Federal Revenue Act under the Sixteenth Amendment was taxable when realized, and the latter case holding only that stock dividends issued against accumulated profits of a corporation were not taxable as income. Neither these cases nor the case of *MacLaughlin* v. *Alliance Ins. Co.*, 286 U. S. 244, 76 L. Ed. 1083, *supra*, support the proposition that an enhancement in value accruing before the effective date of the first establishment of a policy to tax income is subject to an income tax. There was no attempt in any of those cases to tax as income an enhancement of value accruing before March 1, 1913, the applicable date of the first Federal Income Tax Act enacted under the Sixteenth Amendment of the Constitution of the United States. They do not support the proposition that a state may constitutionally tax as income an enhancement of capital assets accruing before the first enactment by the State of an income tax act. Petitioner submits that to avoid the perpetuation of the California Supreme Court's misconception of the decisions of this Court it is necessary that this Court review the above cause.

Wherefore, your petitioner prays that this honorable Court grant its Writ of Certiorari directed to the Supreme Court of the State of California requiring a full and complete transcript of the record and of all proceedings of said Supreme Court of the State of California in said case to be duly certified to this Court, to the end that this Court proceed to correct the errors herein complained of, reverse the judgment of said Supreme Court of the State of California, and give to your petitioner such other and further relief as the nature of the cause may require and to this Court may seem meet and proper in the premises.

Los Angeles, California, May 16, 1941.

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BRIEF IN SUPPORT OF PETITION FOR CERTIORARI.

Opinions of the Court Below.

The decision of the Supreme Court of the State of California in this cause denying petitioner's Federal right, rendered and filed on February 20, 1941, is found in the record at pages 19-24. It has not yet been officially reported but may be found in the California Advance Sheets, 17 A. C. 460 and in 110 Pac. (2) 428, and in the appendix to this brief.

Petition for rehearing in the cause by the Supreme Court of the State of California was filed, considered and denied without opinion on March 20, 1941 (R. 25).

Statement of the Case.

During 1933 and 1934 petitioner and certain of his children became the owners by discovery, location and purchase of a 60% undivided interest in mining property in Kern County, California, known as the Silver Queen, and of a mining lease covering a portion thereof. In November, 1934, for a cash consideration of $4,000.00, petitioner and his co-owners gave a sixty day option to purchase said 60% interest in the Silver Queen for $1,000,000.00 in money and $900,000.00 from the proceeds of the property to be paid on a graduated percentage schedule. Also in November, 1934, they gave a sixty day option to purchase the mining lease for $100,000.00. These options were exercised in January, 1935. The lease was transferred on January 11, 1935, and the 60% interest in the Silver Queen was conveyed on January 18, 1935. From the sales made the petitioner realized more than $100,000.00 in cash over his original investment (R. 3-7, 16).

On June 13, 1935, the first California Personal Income Tax Act (Calif. Stats. 1935, Chap. 329, p. 1090) became effective. It purported to tax as income all gains derived from sales of property, whether real or personal, received or accrued on and after January 1, 1935, and adopted by reference sections 111, 112, and 113 of the Federal Revenue Act of 1934 as the basis for computing gains realized from the sale of a capital asset. There was no increase in the value of the properties involved between December 31, 1934, and the respective dates in January, 1935, upon which the options to purchase were exercised and the properties were conveyed (R. 5-6, 6-7), but the respondent Franchise Tax Commissioner treated the difference between the cost of the properties and their selling price as income and levied a deficiency income tax assessment thereon for the calendar year 1935, which was paid by the petitioner under protest (R. 2-3).

Petitioner filed a complaint for the recovery of the amount of the deficiency tax paid, to which complaint respondent filed a general demurrer (R. 17). Said demurrer was sustained without leave to amend by the trial court, and judgment was rendered by it against petitioner and in favor of respondent (R. 18). Petitioner appealed from said judgment to the Supreme Court of the State of California and said Court affirmed said judgment. Petitioner seeks a review by this Court of the decision.

Summary of Argument.

The questions set forth in the Petition for a Writ of Certiorari present the constitutionality, under the Fourteenth Amendment to the Constitution of the United States, of two retroactive features of the first personal income tax law of the State of California relating to capital gains, all of which the demurrer to the complaint admits had accrued prior to January 1, 1935, the law's applicable date, and were realized thereafter but prior to the enactment of the law on June 13, 1935.

This Court has laid down two conditions precedent to the constitutionality of a retroactive feature of a tax law. These are (1) constitutional power to tax the gain, and (2) an existing established policy of taxing it. These two conditions are set forth in

MacLaughlin v. *Alliance Ins. Co.*, 286 U. S. 244, 76 L. Ed. 1083; and

Milliken v. *United States*, 283 U. S. 15, 75 L. Ed. 809.

The California Personal Income Tax Act of 1935 (the pertinent provisions of which are set forth in the appendix to this brief) was enacted June 13, 1935, and imposed a tax on all incomes received after January 1, 1935. All realized capital gains were taxed as income, including gains resulting solely from enhancement in value

prior to January 1, 1935, and subsequent to March 1, 1913.

When the aforesaid Act was adopted by the Legislature of California the first of the foregoing conditions precedent existed, as section 11 of Article XIII of the Constitution of California, adopted in 1879, granted the Legislature authority to assess income taxes.

But the second of the two conditions precedent, namely, an established policy of taxing incomes, did not exist. The Act in question was the first attempt by the State of California to tax individual incomes. No previous policy of taxing such incomes had been formulated or announced by the State, yet the Act includes in taxable income all accretions to capital over a period of more than twenty years prior to the date from which the Act was made applicable, provided only that such accretions be realized—not after the effective date of the Act—but after its applicable date, which is retroactively fixed as January 1, 1935, practically five and one-half months before the Act became a law.

Therefore the retroactive features of the Act do not meet the constitutional requirements laid down by this Court.

The proposition that the due process clause of the Fourteenth Amendment is violated by the provisions of the California Act under consideration is fully established by the analogy to certain gift and estate tax cases decided by this Court, commencing with *Nichols* v. *Coolidge*, 274 U. S. 531, 71 L. Ed. 1184. In that case it was held that the tax first imposed by the Revenue Act of 1918 was violative of due process in so far as it attempted to tax retroactively a transfer to a trustee in contemplation of death when such transfer was irrevocable and was made before the passage of the act, although the trustor died subsequently thereto.

In *Blodgett* v. *Holden*, 275 U. S. 142, 72 L. Ed. 206, it was held by a divided court (both opinions obtaining the same result) that *inter vivos* gifts made in January, 1924, before the passage of the Revenue Act enacted June 2, 1924, im-

posing a tax upon all gifts made during the calendar year 1924 and subsequently, were not subject to said tax. Later in *Untermyer* v. *Anderson,* 276 U. S. 440, 72 L. Ed. 645, this Court definitely declared that said Revenue Act of 1924 was unconstitutional in so far as it attempted to tax gifts made prior to its enactment, saying:

> "In the light of arguments advanced by counsel in the present cause the matter has been considered by all members of the court and a majority of them are of the opinion that the gift tax provisions of the Act of 1924 here challenged must be construed as applicable to gifts made during the entire calendar year 1924. And, further, that so far as applicable to bona fide gifts not made in anticipation of death and fully consummated prior to June 2, 1924, those provisions are arbitrary and invalid under the due process clause of the 5th Amendment.
>
> "The mere fact that a gift was made while the bill containing the questioned provisions was in the last stage of progress through Congress we think is not enough to differentiate this cause from the former one and to relieve the legislation of the arbitrary character there ascribed to it * * *. The taxpayer may justly demand to know when and how he becomes liable for taxes—he cannot foresee and ought not to be required to guess the outcome of pending measures. The future of every bill while before Congress is necessarily uncertain. The will of the lawmakers is not definitely expressed until final action thereon has been taken" (*Untermyer* v. *Anderson,* 276 U. S. 440 at 445-446, 72 L. Ed. 645 at 647).

Similarly, in *Coolidge* v. *Long,* 282 U. S. 582, 75 L. Ed. 562, this Court held that the State of Massachusetts could not constitutionally tax under its inheritance tax law, as a gift in contemplation of death, the trust involved in *Nichols* v. *Coolidge,* 274 U. S. 531, 71 L. Ed. 1184, *supra,* because when the trust was created no such law had been enacted, saying:

> "We conclude that the succession was complete when the trust deeds of Mr. and Mrs. Coolidge took effect, and that the enforcement of the statute imposing the excise in question would be repugnant to the contract clause of the Constitution and the due process clause of the 14th Amendment" (*Coolidge* v. *Long*, 282 U. S. 582 at 605-606, 75 L. Ed. 562 at 571).

Each of the foregoing four cases held that the retroactive provision of the law under consideration was violative of due process under the Federal Constitution, because it was an entirely *new law reaching a new subject of taxation*, not a law amending an existing system of taxation on the subject, and in each case the facts involved related to a transaction *entirely completed before the passage of the law.* Not only in each case did the law relate to a past and completed transaction, but it also imposed a tax that the taxpayer *could not have foreseen or anticipated* at the time he planned and completed the transaction. Furthermore, in each of these cases it was held that the act on the part of the taxpayer that resulted in the imposition of the tax *was a voluntary act*, that is, one he did not have to perform unless he wanted to, and one which he *had no warning or reason to foresee would later be made subject to the imposition of a new tax*—if he had, he might not have performed the act, or if he had decided to do so the warning would have given him an opportunity to have worked out some plan by which to have avoided the tax.

Milliken v. *United States*, 283 U. S. 15, 75 L. Ed. 809, *supra* (which held that the retroactive provision of the Estate Tax Law of 1918 was not unconstitutional) by its analysis of three of the foregoing cases and the distinction that it draws between the situation presented by them and that presented by the facts in that case but clarifies and strengthens the petitioner's position herein. That case related to the provisions of the Revenue Act of 1918 that

amended the Act of 1916 and increased the rates of tax over those set forth in the 1916 Act upon transfers of property made in contemplation of death. While the 1916 Act was in force a man gave to his children certain shares of corporate stock. The donor died in 1920, and the Commissioner included the shares of stock in the decedent's estate and taxed the value of the stock at the rates in the 1918 Act. The petitioners argued that the taxing statute as applied was a denial of due process of law because retroactive. In considering this contention this Court said:

> "This court has held the taxation of gifts made, and completely vested beyond recall, before the passage of any statute taxing them, to be so palpably arbitrary and unreasonable as to infringe the due process clause." (*Milliken* v. *United States,* 283 U. S. 15 at 20-21, 75 L. Ed. 809 at 814.)

The opinion then proceeds to analyze each of the four foregoing cases, except *Blodgett* v. *Holden,* in support of the quoted statement. It then calls attention to the fact that when the gift was made it was subject to the provisions of the 1916 Revenue Act. The opinion concludes with a statement of why, under the facts of the case and the provisions of the 1916 Act, the retroactive feature of the 1918 Act was not unconstitutional, in the following language:

> "It (the 1918 Act) is thus an enactment in aid of, and an integral part of, the legislative scheme of taxation of transfers at death. Decedent's gift as a substitute for a testamentary disposition was thus brought within the operation of the 1916 Act taxing such gifts on the same basis, with respect to rate and valuation, as transfers of property at death. Not only was the decedent left in no uncertainty that the gift he was then making was subject to the provisions of the existing statute, but in view of its well understood purpose he should be regarded as taking his chances of any in-

crease in the tax burden which might result from carrying out the established policy of taxation under which substitutes for testamentary gifts were classed and taxed with them.

"The reasonableness of the present application of the increased rate of tax of the 1918 Act must be determined in the light of the legislative policy which the 1916 Act had established before the gift was made. Obviously, that policy would be set at naught if gifts made in contemplation of death, after the 1916 Act, were to be taxed more favorably than transfers from the donor occurring at and by reason of his death * * * The decedent, when he made his gift, was as well warned that it might be taxed on that basis (of an estate passing at death) as he was that it would be so taxed if on that day he had made the same disposition of it by will. A change in the rate applicable to transfers at death necessitates a corresponding change in the rate applicable to gifts made in contemplation of death, else the purpose in taxing the latter would not be attained."

Milliken v. *United States*, 283 U. S. 15 at 23-24, 75 L. Ed. 809 at 815-816.

Point I.

The provision of the First Personal Income Tax Act of California making it apply to the gains upon a voluntary sale realized after the applicable date but before the effective date of the Act is unconstitutional.

All of the cases cited or discussed in the foreging Summary of Argument support the point above stated. We have not been able to find any case that disagrees with it except the instant decision of the Supreme Court of California.

The decision in question does not recognize or discuss this point in its entirety. The California Court fails to recognize the fundamental distinction existing between a

first tax law in a jurisdiction and an *amendatory* law. It loses sight of whether when the law under consideration was adopted there existed *an established policy of taxing* the thing in question. This is apparent from the fact that the only cases of this Court cited on this point are *Brushaber* v. *Union Pacific Railroad Co.*, 240 U. S. 1, 60 L. Ed. 493, embodying a quotation from *Stockdale* v. *The Insurance Companies,* 20 Wall. 323, 22 L. Ed. 348, and *Welch* v. *Henry,* 305 U. S. 134, 83 L. Ed. 87.

Stockdale v. *The Insurance Companies,* 20 Wall. 323, 22 L. Ed. 348, *supra,* did not involve a law taxing for the first time a new subject. This Court there had before it a section of the Act of 1870 "construing" certain sections of the Revenue Act of 1864. That the Act was amendatory of an existing established policy of taxation is apparent from the following statement in the opinion:

> "A critical view of the whole of the Statute of 1870 shows that it was designed to recast the internal revenue laws, to repeal some taxes, modify others, and declare the re-enactment or continuance of others for a limited time. And this was especially true of the class of taxes embraced under the general head of income taxes of all kinds."
>
> *Stockdale* v. *The Insurance Companies,* 20 Wall. 323, 22 L. Ed. 348.

Welch v. *Henry,* 305 U. S. 134, 83 L. Ed. 87, *supra,* also involved a law amendatory of a long established policy of taxing incomes in Wisconsin. Even so the question arose as to whether the retroactive provision of this amendatory law was constitutional. The Supreme Court of Wisconsin thought it might "approach or reach the limit of permissible retroactivity", and the majority of this Court, quoting the statement, said "we cannot say that it exceeds it." While fundamentally distinguishable because the retroactive feature there in question was embodied in an amendatory law,

it recognizes the grounds enunciated in the gift tax cases hereinbefore considered for holding the retroactive application of a law placing a new tax on a new subject of taxation unconstitutional, and lays down some new tests of applicable interest here, none of which was given consideration by the Supreme Court of California.

The act involved was adopted by the Wisconsin Legislature on March 27, 1935, and amended the Wisconsin income tax law in force in 1933 so as to impose a tax on corporate dividends received in 1933 from corporations whose principal business was "attributable to Wisconsin," as the term was defined by the 1933 statute, that were not taxed by said statute. Thus the Act of 1935 taxed dividends received in 1933 that had escaped taxation at a time when other dividends and forms of income were being taxed.

This Court then reviewed the gift tax cases, and said:

> "In the cases in which this Court has held invalid the taxation of gifts made and completely vested before the enactment of the taxing statute, decision was rested on the ground that the nature or amount of the tax could not reasonably have been anticipated by the taxpayer at the time of the particular voluntary act which the statute later made the taxable event. Nichols *v.* Coolidge, 274 U. S. 531, 542, 71 L. Ed. 1184, 1192, 47 S. Ct. 710, 52 A. L. R. 1081; Untermyer *v.* Anderson, 276 U. S. 440, 445, 72 L. Ed. 645, 647, 48 S. Ct. 353 (citing Blodgett *v.* Holden, 275 U. S. 142, 147, 72 L. Ed. 206, 210, 48 S. Ct. 105); Coolidge *v.* Long, 282 U. S. 582, 75 L. Ed. 562, 51 S. Ct. 306. Since, in each of these cases the donor might *freely have chosen to give or not to give,* the taxation, after the choice was made, of a gift which he might well have refrained from making had he anticipated the tax, was thought to be so arbitrary and oppressive as to be a denial of due process. But there are other forms of taxation whose retroactive imposition cannot be said to be similarly offensive, *because their incidence is not on the voluntary act of the taxpayer.* And even a retroactive

gift tax has been held valid *where the donor was forewarned by the statute books of the possibility of such a levy.* Milliken *v.* United States, 283 U. S. 15, 75 L. Ed. 809, 51 S. Ct. 324, supra." (P. 147. Italics supplied.)

After stating that "In each case it is necessary to consider the nature of the tax and the circumstances in which it is laid," this Court proceeded to state:

"Property taxes and benefit assessments of real estate, retroactively applied, are not open to the objection successfully urged in the gift cases. (Citing cases.) Similarly, a tax on the receipt of income is not comparable to a gift tax. We can not assume that stockholders would refuse to receive corporate dividends even if they knew that their receipt would later be subjected to a new tax or to the increase of an old one." (Pp. 147 and 148.)

Further, it is said:

"*The equitable distribution of the costs of government* through the medium of an income tax is a delicate and difficult task. In its performance experience has shown the importance of reasonable opportunity for the legislative body, *in the revision of tax laws,* to distribute increased costs of government among its taxpayers in the light of present need for revenue and with knowledge of the sources and amounts of the various classes of taxable income during the taxable period preceding *revision.*" (P. 149. Italics supplied.)

Welch v. *Henry,* 305 U. S. 134 at 147-149, 83 L. Ed. 87 at 93.

From the last quotation it is evident that in deciding the case this Court kept in mind that it was dealing with an amendatory law. With that and the nature of the tax and the circumstances under which it was laid in mind, it would appear that the two controlling factors in the case were:

1. The receipt of the dividends involved was *not dependent upon the voluntary act of the taxpayer.* They were declared and paid without any exercise of choice or the making of any decision by him; and

2. The retroactive imposition of the tax *equalized* among all taxpayers the distribution of *the costs of government.*

Neither of these factors is present in the instant case. (1) It does not involve the receipt of any form of involuntary income such as dividends. The gains received were wholly dependent upon the *voluntary* act of the petitioner. (2) The *retroactive imposition of the tax did not equalize the distribution of the costs of government.* It did the very reverse, as it made petitioner pay taxes on income that had all accrued over a period of time during which all income actually received by others was wholly exempted from taxation.

Brushaber v. *Union Pacific R. R. Co.,* 240 U. S. 1, 60 L. Ed. 493, *supra,* is the only case cited by the California Supreme Court dealing with the retroactive feature of a tax law where an established policy of taxing did not already exist. However, a consideration of the underlying facts discloses the distinctions that render that decision inapplicable to the facts in the case of the petitioner. That case held that the Union Pacific Railroad Company should include in its income tax return for 1913 all income received after March 1, 1913. The facts present at least three fundamental distinctions: (1) The tax there involved applied to all taxpayers equally, being imposed in so far as capital gains were concerned on all such gains accrued *and* realized at any time after March 1, 1913. The tax under the Act here in question is imposed on capital gains accrued after March 1, 1913, *only* if such gains were realized *after* January 1, 1935, whereas similar gains which were realized *before* January 1, 1935, are not taxed. (2) The Railroad

Company was operating a transportation system. Its income arose from passenger fares and freight charges. *It did not involve realized capital gain.* Its transactions were *not separable voluntary transactions,* as the term is used in the tax cases. It could not have decided not to carry out any transaction in order to save the imposition of the tax. Petitioner's transaction was both *separable* and *voluntary,* and he could have saved the imposition of the tax if he had been given the opportunity. (3) The Railroad Company *had warning* in advance that such an act was about to be passed—it did not come as an unforeseen event, for the reason that the Sixteenth Amendment had been ratified before March 1, 1913, and it was public knowledge that it was adopted for the purpose of permitting the levying without apportionment of an income tax. The petitioner had no warning of the impending law, either when he gave the sixty day options in November, 1934, or when he received the money upon the completion of the transactions in January, 1935. The power (under the California Constitution) to impose such a tax, unused since 1879, instead of giving him warning, allayed, rather than aroused suspicion of immediate action.

Point II.

The provision of the First Personal Income Tax Act of California taxing income resulting from capital increment accrued prior to the date from which the Act was made applicable is unconstitutional.

A. *Such a Provision Is So Arbitrary and Capricious as to Amount to a Denial of Due Process of Law.*

The opinion of the Supreme Court of California gave no consideration to this second point. As heretofore stated, the Act under consideration was the first attempt by the State of California to tax individual incomes. The Act in-

cludes in taxable income all capital accretions that may have arisen since March 1, 1913, a period of more than twenty years prior to the applicable date of the Act. This is accomplished by incorporating by reference in Section 7 (d) of the Act, Sections 111, 112 and 113 of the Federal Revenue Act of 1934 (Appendix, *infra*, pp. 30-32) thereby making March 1, 1913, value, or subsequent cost, the basis upon which all capital gains shall be computed. No sound reason or basis is established for using the March 1, 1913, date. Under the Federal revenue acts that date was clearly adopted because it was the first convenient and reasonable date after the ratification of the Sixteenth Amendment, which was ratified February 25, 1913, and said March 1, 1913, date was established by the first Federal revenue act under the Sixteenth Amendment, which act was enacted October 3, 1913.

The petitioner does not object to the fact that the 1935 Legislature of California adopted the Federal *method* of computing capital gains and losses. What petitioner does object to is the very patent fact that in so doing the Legislature lost sight of the *manner* in which Congress applied the method. The manner in which Congress applied the method resulted in a reasonable law, just and fair to all taxpayers and, with respect to the aspect we are now considering, not unreasonably retroactive. While the work of the California Legislature resulted in a law so unreasonably retroactive that it is harsh, arbitrary and discriminatory.

If the *first* Income Tax Act of 1913 had been adopted by Congress on a basis similar to that of the California 1935 Act, Congress would have had to provide no change in the *method* of computing capital gains and losses, but only placed the date to which the method should apply back some twenty-two years to March 1st or January 1st, 1891. And Congress could have done so because during all that time

it possessed the *constitutional power* to tax incomes. The Sixteenth Amendment did not extend its taxing power; it simply removed the necessity for the apportionment among the States of income taxes, when levied. No court would have upheld such unreasonable retroactivity. The unconstitutionality of the retroactive feature would have been recognized by all. Nevertheless, that is exactly what the California Legislature did when it passed the Personal Income Tax Act of 1935, and that retroactive provision of the Act petitioner contends is unconstitutional.

On March 1, 1913, everyone knew that a Federal income tax law would be passed, as the Sixteenth Amendment had been ratified on February 25, 1913, and had been in the process of ratification and extensively discussed for some years prior thereto. All that remained to be done was to formulate and pass a law. No one was taken by surprise. Congress determined, such being the situation, that it would make its first Revenue Act include all income received after March 1, 1913. It went further and, in order to treat all types of income alike, it provided that capital gains that had accrued after March 1, 1913, when realized, should also be treated as income. But March 1, 1913, was the dead line. No accruals before that date were to be included, for the law provided that, in determining capital gains realized after March 1, 1913, the value of the property on March 1, 1913, must be used as the basis for computation. Consequently, a taxpayer with a capital gain, no matter how long it had been accruing, was not discriminated against, as only the accruals after March 1, 1913, were to be considered. He was placed on the same basis as a taxpayer who had held property for some years at a profit, but who sold it and realized his profit on February 28, 1913. He was placed on the same basis as a taxpayer who had his capital invested in stocks or bonds or notes and who received his income therefrom annually or at stated lesser

intervals, or as a taxpayer who was in business with a steady turnover, with resultant income and profits. There was no discrimination. No type or class of taxpayer was treated harshly. The Act's provisions were not arbitrary. As the succeeding years went by, the same condition continued. All were paying income taxes alike from and after March 1, 1913. If in 1930 a taxpayer sold a capital asset he had been holding since 1900 and, by reason of the long period, there was a large realized gain, he was treated fairly and protected under the law, as he was taxed only on the accruals after March 1, 1913, during which period he had been paying no taxes thereon, while his fellow taxpayers with investments that brought in annual returns had been paying taxes year after year during that period.

Had the *first* California income tax law been similarly drafted, using the established *method* of the Federal law, but not following that law slavishly or unreasonably by incorporating the March 1, 1913, date, but, instead, an analogously reasonable date from which to compute capital gains and losses, one occurring at least at some time after the bill for the Act had been introduced in the Legislature, the Act would not have been obnoxiously retroactive as relates to the aspect now under consideration.

As adopted, the harsh and discriminatory result of incorporating March 1, 1913, or subsequent cost, as the date from which to compute taxable gains, could not better be illustrated than by the facts of the instant case. Had the sale of petitioner's mining interests been concluded on December 31, 1934, the transaction would not have been subject to the California income tax. But because the transaction was not completed until January 18, 1935, the gains accrued prior to January 1, 1935, were subject to such tax, regardless of over how long a period they had been accruing, just so they had accrued since March 1, 1913.

Petitioner had no more knowledge of the impending tax when he delivered his deed and received his money on January 18, 1935, than he would have had if he had closed the transaction on December 31, 1934, and escape the tax, because not alone was no tax law in existence on January 18, 1935, the framework of the law had then not even been introduced in the Legislature—not until January 25, 1935, and no feature making it retroactive in any respect was introduced into the bill until March 14, 1935. (See Final Calendar of Legislative Business of California Legislature, Fifty-first Session (1935) under Assembly Final History, page 403 and File of Assembly Bills under Assembly Bill No. 1182.)

B. *Such Provision of the Act also Constitutes a Denial of the Equal Protection of the Laws.*

Petitioner, whose income resulted from accretions to capital over a period of years prior to the inception of the taxing act involved, is, under the Act, required to contribute to the cost of Government by a tax on such income, while others who may have received as much, or more, income over the same period by realizing on their capital assets prior to January 1, 1935, escape entirely from such tax. This provision of the Act does not accomplish an equitable distribution of the costs of Government, but the very reverse. The situation presented by the facts in the instant case are entirely different from those in *Welch* v. *Henry*, 305 U. S. 134, 83 L. Ed. 87, *supra*, where it was held that the retroactive taxation of a certain type of dividends that had previously escaped taxation when other types were being taxed did not constitute discrimination but resulted in an equitable distribution of the costs of Government.

There is no reasonable basis for the discrimination resulting from the provision of the California Personal Income Tax Act of 1935 under consideration, nor does the

Act undertake in any way to justify the same. The situation created by the Act as applied to the facts of the instant case, constitutes a denial to the petitioner of the equal protection of the laws.

POINT III.

The decision of the Supreme Court of California in this case is based upon a misconception and a misapplication by that court of the decisions of this Court.

Petitioner has pointed out in his Petition for a Writ of Certiorari that the cases of *Merchants' Loan & Trust Co.* v. *Smietanka,* 255 U. S. 509, 65 L. Ed. 751, and *Eisner* v. *Macomber,* 252 U. S. 189, 64 L. Ed. 521, referred to in the opinion of the Supreme Court of California in this case, do not sustain the constitutionality of a provision in the first tax law of a jurisdiction taxing as income an enhancement in the value of capital assets accruing before the applicable date of the law. In neither of those cases was an enhancement in value prior to March 1, 1913, involved.

Heretofore in this Brief, we have considered *Brushaber* v. *Union Pacific Railroad Co.,* 240 U. S. 1, 60 L. Ed. 493, and *Welch* v. *Henry,* 305 U. S. 134, 83 L. Ed. 87, also referred to in the California opinion as supporting the court's decision that the retroactive provisions of the California Act were constitutional.

The principal reliance of the Supreme Court of California in its decision of this case was upon the California case of *Fullerton Oil Co.* v. *Johnson,* 2 Cal. (2d) 162, 39 Pac. (2d) 796, which need not be discussed here further than to state that it is based upon a misconception and a misapplication of the case of *MacLaughlin* v. *Alliance Ins. Co.,* 286 U. S. 244, 76 L. Ed. 1083. That case held that under the Revenue Act of 1928 Congress was empowered to tax capital increment accruing after March 1, 1913, and realized in

1928. Such increment had been taxed under the Revenue Acts of 1913, 1916, 1917, and 1918 but was not taxed under the Revenue Acts of 1921, 1924 and 1926. The decision is clearly based upon the fact that Congress had theretofore established a policy of taxing such increment, and the earlier revenue acts had made March 1, 1913, the date from which such increment should be computed. This Court pointed out clearly what the California court missed, that in that case the question of taxing accretions in value occurring before March 1, 1913, was not involved. This Court said:

> "*Here there is no question of a tax on enhancement of value occurring before March 1, 1913,* the effective date of the Income Tax Act of that year, for the collector asserts no right to tax such increase in value. The fact that a part of the taxed gain, represented increase in value after that date, but before the present taxing act, is without significance. Congress, having constitutional power to tax the gain, *and having established a policy of taxing it,* see Milliken *v.* United States, 282 U. S. 15, 22, 23; 75 L. Ed. 809, 815, 816; 51 S. Ct. 324, may choose the moment of its realization and the amount realized, for the incidence and the measurement of the tax." (Emphasis supplied.)
>
> *MacLaughlin* v. *Alliance Ins. Co.,* 286 U. S. 244, 250, 76 L. Ed. 1083, 1086.

This Court also pointed out in the foregoing quotation that in the *MacLaughlin* case Congress had, long before the passage of the act there in question, established a policy of taxing similar increases in value. The act was simply amendatory of the long established policy. No such policy existed in California at the time of the enactment of the Personal Income Tax Act of 1935.

These misconceptions with respect to the situation in and the holding of the *MacLaughlin* case are responsible more than anything else for what petitioner deems to be the er-

roneous views of the Supreme Court of California upon the constitutionality of certain provisions of the State's first Personal Income Tax Act. To rectify and avoid the perpetuation of the misconception and misapplication of the decisions of this Court in the *MacLaughlin* and other cases by the Supreme Court of California the petitioner submits that it is necessary that this Court review the instant case.

POINT IV.

The decision of the Supreme Court of California in this case is in conflict with the decisions of the courts of last resort of other States.

We have pointed out in the petition that the decisions of the courts of last resort of Wisconsin and Georgia are in conflict upon a similar state of facts with the decision of the Supreme Court of California in this case. See *State* v. *Nygaard*, 163 Wis. 307, 158 N. W. 87; *Norman* v. *Bradley*, 173 Ga. 482, 160 S. E. 413, and *State Revenue Commission* v. *Lazear*, 179 Ga. 167, 175 S. E. 451.

In Massachusetts the case of *Trefry* v. *Putnam*, 227 Mass. 522, 116 N. E. 904, arose under the first income tax law of the State enacted in 1916 under authority of a constitutional amendment ratified in November, 1915. The statement on the subject here in question was *dictum*, since it was made in connection with a discussion respecting dividends declared and paid *after* the effective date of the law, but it is pertinent and indicates the trend of the Supreme Judicial Court of Massachusetts on the subject. The court said:

> "A very different question would arise if the attempt were made to tax as income the increase in value of the capital investment in intangibles which had accrued to the owner from a date of purchase long anterior to the enactment of the tax act. Such a construction of a statute would not be adopted except as

the imperative result of unequivocal words, *and even then serious questions might arise as to the validity of such an act.*" (Emphasis supplied.)

Trefry v. *Putnam*, 227 Mass. 522, 116 N. E. 904 at 909.

We have been unable to find any State where the court of last resort has held upon a similar state of facts in harmony with the decision of the Supreme Court of California in the instant case. The petitioner submits that in view of this situation a decision of this Court in this case is desirable in order to establish uniformity of decisions and in order to determine the correct rules for the legislatures and courts of the respective States to follow, and that it is in the interest of public welfare that the existing uncertainty be removed.

Conclusion.

It is respectfully submitted that for the protection of the constitutional rights of the petitioner, as well as those of other taxpayers similarly situated, this Court should review the above cause as prayed in the petition for a writ of certiorari to which this brief is appended.

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Los Angeles, California, May 16, 1941.

APPENDIX.

The pertinent provisions of the California Personal Income Tax Act of 1935 are as follows:

"CHAPTER 329.

"An act to provide for the levy and collection of a tax upon the incomes of individuals, estates and trusts, and to provide for the disposition of the revenues therefrom, and to provide that this act shall take effect immediately.

(Approved by the Governor June 13, 1935. In effect immediately.)

"The people of the State of California do enact as follows:

* * * * * * *

"Sec. 5. *Imposition of Tax on Residents and Nonresidents.*—(a) There shall be levied, collected and paid for each taxable year upon the entire net income of every resident of this State and upon the net income of every nonresident which is derived from sources within this State, taxes in the following amounts and at the following rates upon the amount of net income in excess of credits against net income provided in Section 10:

* * * * * * *

"Sec. 6. *Net Income.*—The words 'net income' mean the gross income computed under section 7 of this act less the deductions allowed by section 8 of this act.

* * * * * * *

"Sec. 7. *Gross Income.*—(a) Gross income includes gains, profits, and income derived from salaries, wages or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal growing out of the ownership or use of or

interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever, and includes any salary, wages or compensation of any officer or employee of this State, or any political subdivision, district or municipality thereof.

* * * * * * *

"(d) In the case of a sale or other disposition of property, the gain or loss shall be computed as provided in sections 111, 112 and 113 of the Revenue Act of 1934 which sections and the sections referred to therein are hereby referred to and incorporated with the same force and effect as though fully set forth herein; provided, however, that the words 'with the approval of the secretary' in said sections shall be deemed omitted.

* * * * * * *

"Sec. 36. *Taking Effect of the Act.*—This act, inasmuch as it provides for a tax levy for the usual current expenses of the State, shall, under the provisions of section 1 of Article IV of the Constitution, take effect immediately, and shall apply to the net income of persons taxable hereunder received or accrued on and after January 1, 1935."

California Personal Income Tax Act of 1935, Chap. 329; California Statutes 1935, pp. 1090, 1093, 1094, 1095, 1123.

Revenue Act of 1934.

The provisions of the Revenue Act of 1934 incorporated by reference in the foregoing Act, which are relevant to the discussion in the instant case are as follows:

"Sec. 111. Determination of Amount of, and Recognition of, Gain or Loss.

"(a) *Computation of Gain or Loss.*—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis pro-

vided in section 113(b) for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

* * * * * * *

"SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

"(a) *Basis (unadjusted) of Property.*—The basis of property shall be the cost of such property; except that—

* * * * * * *

"(14) *Property Acquired before March 1, 1913.*—In the case of property acquired before March 1, 1913, if the basis otherwise determined under this subsection, adjusted (for the period prior to March 1, 1913) as provided in subsection (b) is less than the fair market value of the property as of March 1, 1913, then the basis for determining gain shall be such fair market value. In determining the fair market value of stock in a corporation as of March 1, 1913, due regard shall be given to the fair market value of the assets of the corporation as of that date.

"(b) *Adjusted Basis.*—The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided."

Revenue Act of 1934, Vol. 48 U. S. Stat. at L., Part I, Chap. 277, pp. 703, 706, 708-709.

Section 1 of the Fourteenth Amendment to the Constitution of the United States:

"Section 1. All persons born or naturalized in the United States, and subject to the jurisdiction thereof, are citizens of the United States and of the State wherein they reside. No State shall make or enforce any law which shall abridge the privileges or immunities of citizens of the United States; nor shall any State deprive any person of life, liberty, or property, without due process of law; nor deny to any person within its jurisdiction the equal protection of the laws."

Opinion of the California Supreme Court.

(L. A. No. 17306. In Bank. February 20, 1941)

M. A. HOLMES, Appellant,

v.

CHARLES J. McCOLGAN, as Bank and Corporation Franchise Tax Commissioner, etc., Respondent.

Appeal from a judgment of the Superior Court of Los Angeles County. Joseph W. Vickers, Judge. Affirmed.

Ralph D. Brown for Appellant.

Earl Warren, Attorney-General, H. H. Linney, James J. Arditto and Valentine Brookes, Deputies Attorney-General, and Roger J. Traynor for Respondent.

GIBSON, *C. J.*:

This action was brought to recover money alleged to have been illegally assessed and collected as personal income taxes for the calendar year 1935. A general demurrer to the complaint was sustained without leave to amend and judgment was rendered in favor of defendant. Plaintiff appeals from the judgment.

The following facts are set forth in the complaint: In 1933 and 1934 plaintiff and certain of his children became the owners by discovery, location and purchase of an interest in mining property situated in Kern County, California, known as the Silver Queen, and a mining lease of a portion thereof known as the Emrick-Holmes lease.

In November, 1934, for a cash consideration of $4,000 they gave an option to purchase a 60 per cent interest in the Silver Queen for $1,000,000 in money and $900,000 from the proceeds of the property to be paid on a graduated percentage schedule of the production therefrom. At approximately the same time they granted an option for the purchase of the Emrick-Holmes lease for a cash consideration of $100,000.

The options were exercised in January, 1935, and the sellers received for their 60 per cent interest in the Silver

Queen a cash payment of $271,000, a series of notes totalling $725,000, and an agreement covering payments to be made from production; and for the Emrick-Holmes lease they received $100,000 cash. Plaintiff received $108,400 as his share of the cash payment on the purchase price of the Silver Queen and $16,666.66 as his share of the sum paid for the Emrick-Holmes lease.

There was no increase in the value of the property between January 1, 1935, the applicable date of the Personal Income Tax Act, and the date of sale. The defendant Franchise Tax Commissioner treated the difference between the cost of the property and the selling price thereof as income and imposed and collected a personal income tax thereon.

Appellant contends that no part of the proceeds of these sales is income within the meaning of the act and that the increase in value of the property which accrued prior to January 1, 1935, and was realized by sale subsequent thereto, but prior to the enactment of the law on June 13, 1935, cannot legally be taxed as income. He advances the theory that on January 1, 1935, the property constituted a capital asset, and that the proceeds from the sales therefore represented a return of capital and not income. He contends that the act cannot be applied to these proceeds without violating article I, section 13 of the Constitution of the State of California and the Fourteenth Amendment to the Constitution of the United States. Briefly, it is his position that the act does not provide for the taxation of the gains in question; and that if it did it would be unconstitutional.

An examination of the Personal Income Tax Act makes it evident that the legislature intended to tax the gains in question. Section 36 makes the tax applicable to net income received or accrued after January 1, 1935. Section 6 of the act defines net income as the gross income computed under section 7 less the deductions allowed by section 8. Section 7 (a) defines gross income as including gains from sales of property, real or personal. Section 7 (d) provides that the method of computing such gains shall follow the

Federal practice as set forth in sections 111, 112 and 113 of the Federal Revenue Act of 1934, which sections and the sections referred to therein are incorporated by reference. Under section 7 (d) of the California act appellant's gain, by reference to the provisions of the Federal act, is the excess of the sale price of the property over its cost. Its realization after January 1, 1935, brings it directly within the provisions of the act.

Despite the applicability of the act, however, its constitutionality is brought into question by appellant's contentions that the gain in question is capital and therefore not taxable as income, and that the act, adopted on June 13, 1935, cannot be applied retroactively to January 1, 1935.

The first contention seeks to revive an issue squarely presented to this court in *Fullerton Oil Co.* v. *Johnson*, 2 Cal. (2d) 162, 167-172 (39 Pac. (2d) 796), and decided adversely to appellant's contention in an opinion which fully considered the question he raises.

That case involved the Bank and Corporation Franchise Tax Act which imposed a tax measured by net income and which incorporated by reference the Federal method for computing gain or loss in its provisions for the depletion allowance for oil and gas wells. The adoption of that method brought gains accruing before the effective date of the act but realized thereafter into the measure of the tax, and the court stated that "the main point to be determined" was whether such gains were capital and not income and therefore constitutionally beyond the province of the tax. To this question it gave a clear answer: " * * * it is our opinion the tax here involved is one measured by income and not capital. It is true that by the 1931 amendment respondent is deprived of the opportunity of using the January 1, 1928, values as a base, and that it must use the cost of March 1, 1913, values as a base. It is further true that in thus computing the depletion allowance any increase in value in the properties between 1913 and 1928 would thus be included in the tax base. That fact, however, does not make the tax one measured by capital as distinguished from income as those two terms are usually understood, and are

used in the act here involved. Under the Federal Income Tax Act the Federal courts have established the principle that 'income' within the meaning of the Income Tax Act is 'realized gain', and that such realized gain is taxable in the year of its realization regardless of when it accrued. Thus under the Federal act increases in the value of capital assets accruing subsequent to March 1, 1913, are taxable as income not in the year such increases in value occur, but in the year such increases in value are actually realized by sale or other transfer. (*Merchants Loan & Trust Co.* v. *Smietanka,* 255 U. S. 509; *Eisner* v. *Macomber,* 252 U. S. 189). * * * We can see no constitutional difference between accretions to capital prior to the date of the taxing statute and those occurring subsequent thereto. If increases in the value of property constitute income, and constitute income in the year in which realized rather than in the years when such increases in value accrue, it would seem that constitutionally speaking it makes no difference when such increases in value accrue—whether before or after the effective date of the taxing statute. This very point has already been decided in accordance with the above views by the United States Supreme Court."

In the light of this judgment of the court, and the compelling reasons for following established Federal practice to insure effective administration of the act, the legislature adopted the Federal method of computing capital gains and losses in the Personal Income Tax Act as it did in the Bank and Corporation Franchise Tax Act. A departure from Federal practice in this respect might easily create myriad administrative difficulties inimical to the interests of both the state and the taxpayers. The legislature has consistently followed the Federal provisions generally in the Personal Income Tax Act. This policy makes available to the state a ground work of relevant Federal experience and judicial pronouncements. "It is a cardinal principle of statutory construction that where legislation is framed in the language of an earlier enactment on the same or an analogous subject, which has been judicially construed, there is a very strong presumption of intent to adopt the construction as well as the language of the prior enactment.

* * * A similar principle applies where a statute is patterned after legislation of another state, or of the Federal government, or, indeed of a foreign country, which has been judicially construed in the jurisdiction of its enactment." (*Union Oil Associates* v. *Johnson*, 2 Cal. (2d) 727, 734 (43 Pac. (2d) 291).

The limited retroactivity of the act to which appellant objects is characteristic of the generally accepted practice of making a tax law applicable, beginning usually on January 1st, to that part of the year which precedes its enactment. When a similar objection was raised to the Federal Income Tax Act of 1913, the United States Supreme Court stated in Brushaber *v.* Union Pac. R. R. Co., 240 U. S. 1: "The statute was enacted October 3, 1913, and provided for a general yearly income tax from December to December of each year. Exceptionally, however, it fixed a first period embracing only the time from March 1, to December 31, 1913, and this limited retroactivity is assailed as repugnant to the due process clause of the Fifth Amendment, and as inconsistent with the Sixteenth Amendment itself. But the date of the retroactivity did not extend beyond the time when the Amendment was operative, and there can be no dispute that there was power by virtue of the Amendment during that period to levy the tax, without apportionment, and so far as the limitations of the Constitution in other respects are concerned, the contention is not open, since in *Stockdale* v. *Atlantic Ins. Co.*, 20 Wall. 323, 331, in sustaining a provision in a prior income tax law which was assailed because of its retroactive character, it was said: 'The right of Congress to have imposed this tax by a new statute, although the measure of it was governed by the income of the past year, cannot be doubted; much less can it be doubted that it could impose such a tax on the income of the current year, though part of that year had elapsed when the statute was passed.' "

The principle of the Brushaber case is applicable here. It is reiterated in *Roth Drug, Inc.* v. *Johnson*, 13 Cal. App. (2d) 720 (57 Pac. (2d) 1022), upholding the validity of the Retail Sales Tax Act of 1933, even though retroactively applied to gross receipts from retail sales. In *Welch* v.

Henry, 305 U. S. 134, the United States Supreme Court went much beyond the Brushaber case in upholding a Wisconsin tax on dividends which was retroactive from 1935 to 1933. The constitutional validity of such retroactive provisions is now too well established to be questioned.

The judgment is affirmed.

GIBSON, *C. J.*

We concur:

CURTIS, *J.*, SHENK, *J.*, EDMONDS, *J.*, SPENCE, *J.*, pro tem., and CARTER, *J.*, concurred.

TRAYNOR, *J.*, took no part in the consideration or decision of this case.

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CHARLES ELMORE C

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1941

No. 147

M. A. HOLMES,

Petitioner,

vs.

CHARLES J. McCOLGAN, as Bank and Corporation Franchise Tax Commissioner of the State of California,

Respondent.

RESPONDENT'S BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

EARL WARREN,
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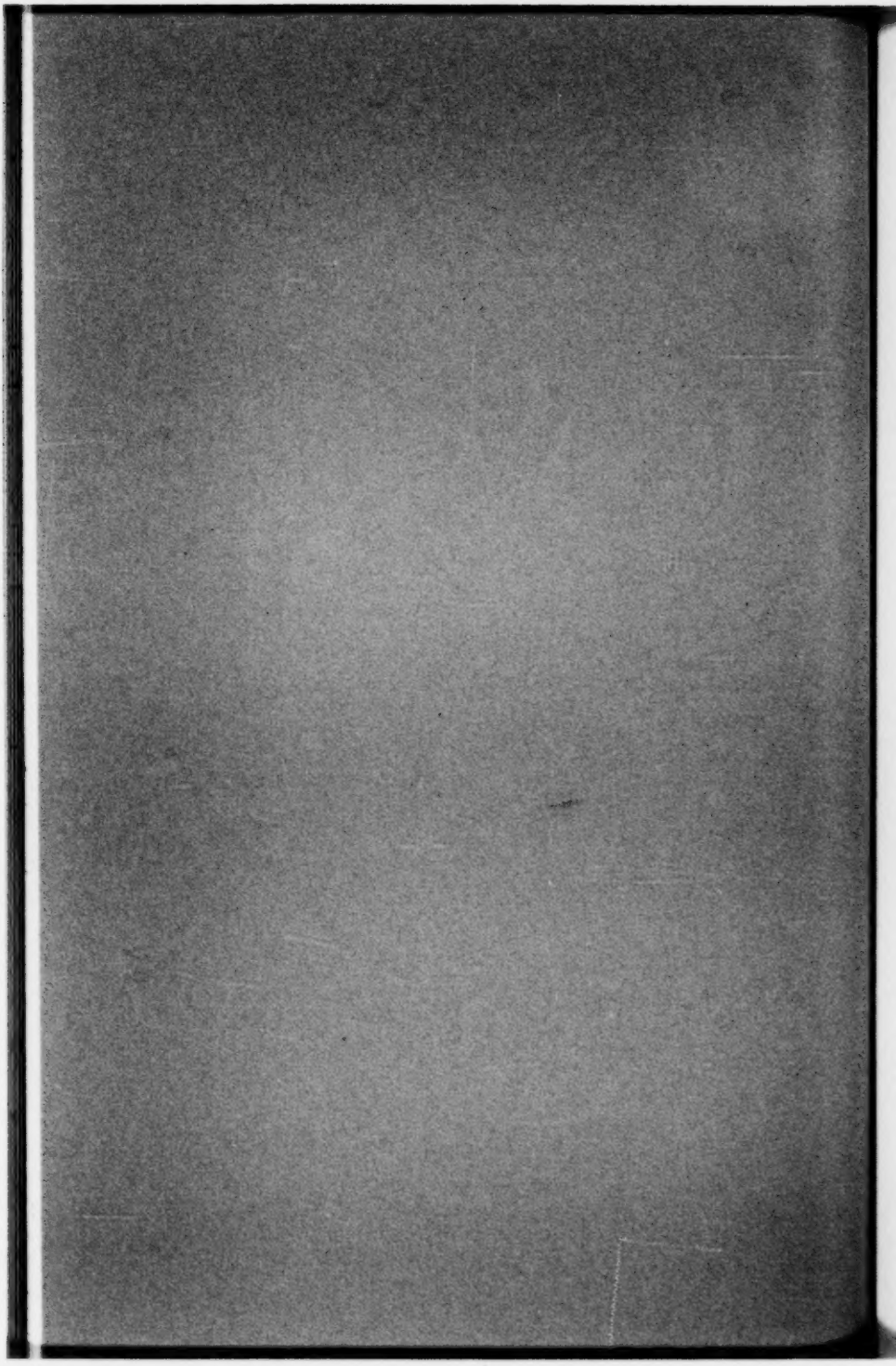

TABLE OF CONTENTS

	Page
STATEMENT OF THE CASE	1
SUMMARY OF ARGUMENT	2
ARGUMENT	3
I. The Provision of the First Personal Income Tax Act of California Making It Apply to the Gains Upon a Voluntary Sale Realized After the Applicable Date But Before the Effective Date of the Act Is Not Unconstitutional	3–8
II. The Provision of the First Personal Income Tax Act of California Taxing Income Resulting From Capital Increment Accrued Prior to the Date From Which the Act Was Made Applicable Is Not Unconstitutional	9–14
A. Such a Provision Is Not So Arbitrary and Capricious as to Amount to a Denial of Due Process of Law	9–12
B. Such Provision of the Act Does Not Constitute a Denial of the Equal Protection of the Laws	13–14
III. The Decision of the Supreme Court of California in This Case Is Based Upon a Correct Interpretation and Application of the Decisions of This Court	14–16
IV. The Decisions of Courts of Other States Which Are in Conflict With the Decision of the California Supreme Court Are Likewise in Conflict With Subsequent Decisions of This Court	17–18
CONCLUSION	19

INDEX TO AUTHORITIES CITED

TABLE OF CASES CITED

	Page
Brushaber v. Union Pacific R. R. Co., 240 U. S. 1	7, 14, 18
Cooper v. United States, 280 U. S. 409	3, 18
Eisner v. Macomber, 252 U. S. 189	11, 14
Fullerton Oil Co. v. Johnson, 2 Cal. 2d 162, 163, 39 Pac. 2d 796	9-10, 15
Glenn v. Doyal, 285 U. S. 526	12, 14, 17
Lucas v. North Texas Lumber Co., 281 U. S. 11	9
MacLaughlin v. Alliance Insurance Co., 286 U. S. 244	11, 14, 15, 17
Merchants Loan and Trust Co. v. Smietanka, 255 U. S. 509	11, 14, 15
Milliken v. United States, 283 U. S. 15	5
New Colonial Ice Co. v. Helvering, 292 U. S. 435	10
Norman v. Bradley, 173 Ga. 482, 160 S. E. 413	17
State v. Nygaard, 163 Wis. 307, 158 N. W. 87	17
State Revenue Com. v. Lazear, 179 Ga. 167, 175 S. E. 451	18
Trefry v. Putnam, 227 Mass. 522, 116 N. E. 904	17
Welch v. Henry, 305 U. S. 134	3, 5, 6, 14, 17

OTHER AUTHORITIES CITED

California Personal Income Tax Act of 1935	
Constitution of the United States	
Fourteenth Amendment	9, 16
Sixteenth Amendment	16
Revenue Act of November 23, 1931	3

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STATEMENT OF THE CASE

The case is correctly stated on pages 10 and 11 of the Brief in Support of the Petition, and Respondent therefore accepts that statement of the case.

SUMMARY OF ARGUMENT

Respondent's argument will follow the same pattern that Petitioner used in his brief, with the headings rephrased to state Respondent's position.

It is Respondent's position, as elaborated in the argument hereinafter, that the retroactive application of the California Personal Income Tax Act to January 1 of the year in which the act was enacted is constitutional and is supported by decisions of this Court. Respondent will also show that the effect of the act in taxing preexisting increment to capital when realized after the applicable date of the act not only does not raise a federal question but is in accord with the principles of income taxation which have been enunciated by this Court. Finally, we will show that the conflict of the decision of the California Supreme Court with decisions of courts of other states is not a conflict of nationwide importance, for the California court rested its decision on decisions of this Court which were rendered after the decisions of the state courts which are said to be in conflict with the decision of the California court.

ARGUMENT

Point I

The Provision of the First Personal Income Tax Act of California Making It Apply to the Gains Upon a Voluntary Sale Realized After the Applicable Date But Before the Effective Date of the Act Is Not Unconstitutional

Not one of the decisions of this Court relied upon by Petitioner in this division of his brief is in point, for each of them involved taxes on gifts, whereas the instant case involves a tax on net income. The distinction is apparent from the decision in *Cooper* v. *United States,* 280 U. S. 409, as well as from *Welch* v. *Henry,* 305 U. S. 134.

Cooper v. *United States,* 280 U. S. 409, like the case at bar, involved a retroactive income tax on capital gain of a type not theretofore taxed. The *Cooper* case upheld the Revenue Act of November 23, 1921, which applied to income for the entire year 1921. Prior to this revenue act, gift property in the hands of the donee had a basis for income tax purposes equal to its value at the time of gift, so that if the donee sold the property he was not taxable on income unless the selling price exceeded the value of the property when it was given to him. The 1921 act, however, reduced that basis for computing gain on the sale of gift property from its value at the time of the gift to the cost or other basis to the donor. Thus under the amendment the

donee would be taxable on income when he sold the property, regardless of whether the selling price exceeded the value of the gift, to the same extent that the donor would have been. This happened to Mrs. Cooper, who sold property given to her by her husband for a price which was exactly equal to the value of the property when it was given to her but which was in excess of the cost of the property to her husband. Both the gift and the sale occurred prior to the enactment of the statute. Had the statute imposed a gift tax on the donor it would have been invalid under the cases on which Petitioner relies. But the donee, who benefited from both the gift and the sale, was the one who was taxed. Although the tax on the donee's income was on a value which was entirely a gift to her, the retroactive tax was held valid. The Court, unanimously and speaking through a member of the majority which decided the cases relied on by Petitioner, held that those cases were not in point in considering the validity of income tax legislation.

The *Cooper* case, which must have influenced the California Supreme Court since it was cited in Respondent's briefs before that court, is not distinguishable from the instant case on the ground that in the *Cooper* case there was an established policy of taxing such gains and the statute was merely amendatory of that policy. Never, before the retroactive act of 1921 upheld the *Cooper* case, was the value of gifts made subject to the

income tax. That act, like the one herein in question, imposed the first tax on the subject which it taxed, and its retroactivity was upheld.

Welch v. *Henry,* 305 U. S. 134, is likewise not susceptible to the distinction offered by Petitioner. The income which the 1935 Wisconsin legislation taxed retroactively had theretofore been exempt from the state income tax, so necessarily the retroactive tax reached a new subject. Thus it did not differ in its material aspects from the instant tax, except in degree of retroactivity, in which the Wisconsin tax far exceeded the California tax.

The attempted distinction regarding amendatory laws which Petitioner offers is born of language in *Milliken* v. *United States,* 283 U. S. 15, where, however, the Court made it very clear that the subject taxed by the retroactive 1918 act was also taxed by the 1916 act. In the *Cooper* case, in *Welch* v. *Henry* and in the instant case the subject retroactively taxed was never before taxed. Thus the distinction Petitioner offers is inconsistent with this Court's decisions.

If, however, one momentarily assumes that Petitioner's distinction has merit and that the retroactive federal tax and retroactive Wisconsin tax on new subjects were upheld only because they emerged from the shelter of pre-existing policies of taxing some incomes (though not those which the amendment taxed), the California tax is nevertheless valid for the same reason. Since 1929 cor-

porate net incomes had been used as the measure of the California franchise tax; thus since 1929 California had had the policy of using net income as a tax base, and its action in 1935 in extending the income tax principle to include individuals' incomes was only amendatory of a preexisting policy.

The real distinction, however, between the gift tax cases and the income tax cases is not that offered by Petitioner but is that which is suggested by the following quotation from the opinion of the Court in *Welch* v. *Henry,* 305 U. S. 134, 148:

> "Similarly, a tax on the receipt of income is not comparable to a gift tax. We cannot assume that stockholders would refuse to receive corporate dividends even if they knew that *their receipt would later be subjected to a new tax* or to the increase of an old one." (Emphasis added.)

The income tax is on profits, on gains, whereas the gift tax is on an act unprofitable and actually costly to the one who is taxed. It is reasonable to assume that one would not have made a gift if he had known that he would be taxed for the privilege, but it is altogether unreasonable to assume that one would have refused to sell property at a profit to avoid a tax which would take but a part of it. Thus we find the Court stating in the above quotation that even a new retroactive tax on profits is not prohibited by the gift tax cases.

The decision in *Brushaber* v. *Union Pacific R. R. Co.*, 240 U. S. 1, likewise fully supports the validity of this tax. Petitioner offers three possible distinctions, none of which has merit. The first distinction is not clear, but it either does not deal at all with retroactivity or, if it does, is a complaint because the California act does not tax all gains realized after March 1, 1913. If the former construction is the correct one, this distinction will be answered later, under Points II and III. If the latter construction is correct, no answer is necessary. The second offered distinction simply is that in the *Brushaber* case there were numerous profitable transactions, whereas in the instant case there were sales of only two properties. But surely the Constitution affords equal protection to those who must engage in numerous transactions to earn profits and to those who need engage in only two. The basis of this attempt distinction is that Petitioner might have foregone his profits rather than pay any of them in taxes to the State of California. As we have seen, this Court has previously found a like assumption too violent. The third distinction is that the Railroad Company had warning whereas Petitioner did not. This distinction has the same faulty basis as the second one, but there is an additional answer to it. In 1933 the California legislature passed a personal income tax act which the governor vetoed. The next legislative session at which revenue bills could be passed was in 1935, and in that year there was as great a need for new

state revenue as in 1933, and, perhaps more important, a new governor. It would have taken no more political acumen to foresee the passage in 1935 of the California act than it would have taken in 1913 to foresee the passage of the 1913 income tax act. Petitioner had the warning to which he claims he was entitled.

Petitioner also seeks to place his case outside the boundaries of the decisions discussed above by asserting that the Personal Income Tax Act did not equalize the costs of government. The basis for this contention is that those who received income during 1933 and 1934 escaped tax, whereas he did not. However, Petitioner did not receive income in 1933 and 1934, for the unrealized increment to his property was not income in those years. Had the state income tax been in effect in those years Petitioner would have escaped tax for those years whereas those who received income would have been taxed. Petitioner received his income in 1935 and he, in common with those others in California who received income in that year, was taxed. Actually this complaint of Petitioner should not have been directed against the retroactivity of the tax, which had nothing to do with the basis on which this complaint is founded, but rather against the fact that the act uses cost as the basis for computing capital gain instead of January 1, 1935 value. As Petitioner attacks the act on this ground elsewhere, we will answer that attack in a later division of this brief.

Point II

The Provision of the First Personal Income Tax Act of California Taxing Income Resulting from Capital Increment Accrued Prior to the Date from Which the Act Was Made Applicable Is Not Unconstitutional

In the title to this division and hereinafter we will accept the use of the word "accrue" and its participles which Petitioner has adopted, although actually the word has become a word of art in tax law, and as such does not have the meaning Petitioner gives to it. Actually Petitioner's gain did not "accrue" until after January 1, 1935.

Lucas v. *North Texas Lumber Co.*, 281 U. S. 11.

The meaning of the word "accrue" was pertinent in a contention, involving the interpretation of the act, unsuccessfully raised by Petitioner in the state courts. As it is no longer pertinent, we will not further protest the somewhat misleading use of that word.

A. Such a Provision Is Not So Arbitrary and Capricious As to Amount to a Denial of Due Process of Law

Petitioner erroneously states that the opinion of the Supreme Court of California gave no consideration to this point. That court first stated that Petitioner contended that the act contravened the Fourteenth Amendment to the Constitution and then held that this contention was already settled adversely to Petitioner in *Fullerton Oil Co.* v. *John-*

son, 2 Cal. (2d) 163, 39 Pac. (2d) 796. This will appear on pages 34 and 35 of the Appendix to the Petition for Certiorari, where the opinion of the state court is printed.

Petitioner objects to the use by California of March 1, 1913 values and points out that that date has no particular relation to California taxes. It is, of course, true that March 1, 1913, has no particular relation to the California tax system; however, the incorporation by reference of the federal statutory provisions which use March 1, 1913, values as an alternative basis for computing capital gain has the effect of using 1913 values solely as a relief provision. The legislature need not have granted taxpayers this relief (Compare *New Colonial Ice Co.* v. *Helvering,* 292 U. S. 435, pointing out that deductions from income are a matter of legislative grace) and its action in having done so is not a cause for constitutional objection. The advantages in copying the federal system are pointed out in the opinion of the California Supreme Court.

The legislative action in taxing all capital gain realized on or after January 1, 1935, results in placing all fortunate property owners on the same plane with those whose earnings come from personal services. All who realized profits on or after January 1, 1935, were taxed regardless of whether those profits were in the form of capital gains, dividends or salaries. The legislature chose a class of taxpayers and laid a tax burden on those taxpayers

which varied according to the benefits enjoyed during the taxable period and the ability to pay.

Petitioner received large monetary benefits during the taxable year and possessed the ability to pay. Although he contends that the tax on him is arbitrary and unreasonable, his possession of the benefits which governments make possible and protect fully justifies his being taxed on those benefits.

Petitioner's argument in this division of his brief is based on two asserted wrongs: one, that the act taxed him retroactively because it taxed him on increment arising before but not realized until after January 1, 1935; two, he is treated unjustly in comparison with those who realized the increment to the value of their property before 1935. The first argument is faulty because the act taxed him on income and his increment did not become income until 1935. Unrealized appreciation in value has never been treated as income and this Court has held that it may not be treated as income under the Sixteenth Amendment.

Eisner v. *Macomber,* 252 U. S. 189.

The practice of taxing capital gain as income only when it has been realized by sale or exchange is well-settled and has judicial approval. See *Merchants Loan and Trust Co.* v. *Smietanka,* 255 U. S. 509, and *MacLaughlin* v. *Alliance Insurance Co.,* 286 U. S. 244. An action is arbitrary and capricious only when it is an unjustified departure from the normal standards of conduct, and such a reli-

gious adherence by the California legislature to the normal concepts of income can not, we submit, be properly characterized as either arbitrary or capricious.

The second assertion of a wrong is faulty for the same reason that the first one is. Those who realized their profits before 1935 received their income before that year whereas Petitioner did not. It is proper to treat differently people situated so differently.

The final answer to Petitioner's assertion that he was denied due process because he was taxed in 1935 on increment existing before that year but realized during it is that this Court has already held an identical objection insubstantial in *Glenn* v. *Doyal,* 285 U. S. 526. *Glenn* v. *Doyal* involved an appeal from the Georgia Supreme Court, which had upheld the first income tax of Georgia in its application to increment existing before 1929 but realized in that year, when the Georgia act was passed. This Court dismissed the appeal because it did not involve a substantial federal question. We submit that that decision establishes that Petitioner's objection is insubstantial.

We note that Petitioner, in this division of his brief as well as in a prior one, contends that he was injured because he had no advance warning that this tax act would be enacted. Although he has no constitutional right to such warning, as we pointed out in the first division of this brief he had the warning to which he claims he was entitled.

B. Such Provision of the Act Does Not Constitute a Denial of the Equal Protection of the Laws

Petitioner has not been discriminated against in any manner. As we pointed out above, under long established concepts of income taxation Petitioner's gain became income for the first time in 1935. He seeks to compare himself with those who realized their capital gains in prior years and whose gains accordingly became income in those years, but he can not justly claim that he must be taxed as if his gain had likewise become income before 1935. There is no discrimination in treating those who receive income in 1935 differently from those who received income from similar sources in years before 1935. While we believe this fact to be self-evident, it is emphasized by realizing that if such different treatment is unconstitutional a state can not validly increase its rate of taxation on gains unless it does so retroactively.

Petitioner's income was not in existence before 1935, although the source of it was. He was in the same situation as a skilled professional man or workman who derived earnings in 1935 from a hard-won proficiency acquired in prior years, but his argument would not exempt these other persons. To exempt Petitioner's gain as he asks would not avoid discrimination against him but would, on the contrary, create the most gross discrimination in his favor and against those who must be content

with the earnings their personal services may bring them.

Possibly it was these considerations which led this Court to conclude in *Glenn* v. *Doyal,* 285 U. S. 526, also discussed above, that a similar argument did not present substantial federal questions. That decision is authority against both of Petitioner's arguments in Point II of his brief.

Point III

The Decision of the Supreme Court of California in This Case Is Based Upon a Correct Interpretation and Application of the Decisions of This Court

The third division of Petitioner's brief merely refers to Petitioner's previous attempted distinction of *Brushaber* v. *Union Pacific R. R. Co.,* 240 U. S. 1, and *Welch* v. *Henry,* 305 U. S. 134, and therefore we need not do more than refer to our own previous discussion of those cases in the first division of our brief.

This division of Petitioner's brief is principally devoted to an attempt to show that the decisions of this Court in *MacLaughlin* v. *Alliance Insurance Co.,* 286 U. S. 244, *Merchants' Loan & Trust Co.,* v. *Smietanka,* 255 U. S. 509, and *Eisner* v. *Macomber,* 252 U. S. 189, were misinterpreted by the California Supreme Court and do not actually support the validity of the act. Petitioner attempts to distinguish *Eisner* v. *Macomber* by pointing out that the actual decision involved the taxability of common stock dividends and not of capital gains.

This attempted distinction completely overlooks the fact that *Eisner* v. *Macomber* has been more often cited by this Court as well as by others for its reasoning than for its decision. The California court cited the case, as has this Court times without number, for the generalization which it fathered that gains do not become income until they are realized. *Merchants' Loan & Trust Co.* v. *Smietanka,* 255 U. S. 509, was cited by the California court as sustaining that same proposition, and even Petitioner admits on page 7 of the Petition that the case supports that proposition.

When it decided *Fullerton Oil Co.* v. *Johnson,* 2 Cal. 2d 162, 39 Pac. 2d 796, the California court relied on *MacLaughlin* v. *Alliance Insurance Co.,* 286 U. S. 244; in which a taxpayer contended that its capital gain had become capital during a period when capital gains were not taxed and therefore the gain could not be taxed as income in the year of realization. This Court held that the gain was taxable when realized even though it was merely a realization of increment which arose during years when capital gain was not taxed. Petitioner attempts to distinguish that case from the present one because in the *Alliance Insurance* case Congress had once before taxed capital gains although none of the increment to the taxpayer's property arose during years when such gain was taxable. Apparently it is Petitioner's notion that the fact that Congress had once taxed capital gains operated as a caveat to property owners, warning them

that if they permitted their property to increase in value they did so at their peril for they might be taxed if they should sell it at a gain. If this is the notion behind the attempted distinction it nevertheless would not be pertinent unless one were to assume that Petitioner would not have permitted his property to increase in value and would not have sold it for a gain had he had a similar caveat. Such an assumption would be quite unreasonable.

The conclusion is compelled that the fact that Congress once before had taxed capital gains whereas California had not has no bearing on the validity of either the 1928 federal tax or of the California tax under the Constitution. The *Alliance Insurance* case was therefore good authority for the California courts.

If, however, one assumed that the California Supreme Court had misinterpreted *Eisner* v. *Macomber, Merchants' Loan & Tr. Co.* v. *Smietanka,* and *MacLaughlin* v. *Alliance Insurance Co.,* that fact would not present a federal question. Those decisions interpreted the Sixteenth Amendment, by which California is not bound or its powers enlarged. California may define income differently from Congress without offending the United States Constitution. The California concept of income is a local question except where a contravention of the Fourteenth Amendment is concerned, and the authorities discussed above show that no denial of due process or equal protection is involved herein.

Point IV

The Decisions of Courts of Other States Which Are in Conflict with the Decision of the California Supreme Court Are Likewise in Conflict with Subsequent Decisions of This Court

Certain decisions of other state courts are stated by Petitioner to be contrary to the decision of the California Supreme Court, but those decisions are also contrary to subsequent decisions of this court.

State v. *Nygaard,* 163 Wis. 307, 158 N. W. 87, holds that increment existing before the enactment of a taxing act but realized thereafter is not taxable. It is inconsistent with the decision below, and also with *Glenn* v. *Doyal,* 285 U. S. 526, and *MacLaughlin* v. *Alliance Insurance Co.,* 286 U. S. 244. Both decisions of this court were rendered after the *Nygaard* case was decided.

Trefry v. *Putnam,* 227 Mass. 522, 116 N. E. 904, merely states that the problem is serious, but if one interprets the case as being in conflict with the decision below, the comments made about the *Nygaard* case become applicable.

Norman v. *Bradley,* 173 Ga. 482, 160 S. E. 413, is in accord with the California court's decision on the problem on which it conflicts with the *Nygaard* decision, but the *Georgia* case conflicts with the California decision regarding the validity of the retroactive feature. However, the *Georgia* decision also conflicts on that point with the subsequent decision of this Court in *Welch* v. *Henry,* 305 U. S. 134,

as well as with the earlier decisions in *Cooper* v. *United States,* 280 U. S. 409, and *Brushaber* v. *Union Pacific R. R. Co.,* 240 U. S. 1.

State Revenue Commission v. *Lazear,* 179 Ga. 167, 175 S. E. 451, is in conflict with decisions of the California Supreme Court and this court to the same extent as *Norman* v. *Bradley.*

Thus each of the decisions by courts of other states in conflict with the decision of the California Supreme Court is likewise contrary to a decision by this Court rendered subsequently to the decision by the other state court. There is no reason to believe that future decisions by state courts will not follow the already existing decisions of this Court, and if any state court should be indisposed to follow the already existing decisions of this Court it would probably be equally indisposed to follow any decision by this Court of the instant case.

We submit that a decision by this Court is not necessary to clarify the law, for decisions by this Court have already clarified it.

CONCLUSION

We urge that the Petition for Writ of Certiorari be denied.

Respectfully submitted.

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